

# IRS News Release

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## **IRS Warns Businesses and Retirement Plans Against Abuses Involving ESOPs and S Corporations**

IR-2004-155, Dec. 22, 2004

WASHINGTON – The Internal Revenue Service has issued letters to approximately 1,700 businesses and retirement plan sponsors alerting them to new income and excise taxes applicable to S corporation employee stock ownership plans (ESOPs) and warning of the consequences of participating in abusive schemes involving ESOPs and S corporations. The letters are being mailed to S corporation ESOPs reporting 10 or fewer participants.

The letters follow recently issued temporary regulations on ESOPs and S corporations, which provide guidance concerning the application of Internal Revenue Code section 409(p).

Congress intended that S corporations, like C corporations, be able to encourage employee ownership through an ESOP. Section 409(p) was enacted to address concerns about ownership structures involving S corporations and ESOPs that concentrate the benefits of the ESOP in a small number of persons. For example, 409(p) imposes income and excise taxes in situations involving abusive arrangements in which an S corporation is used to pass corporate income to a tax-exempt ESOP where the only participants in the ESOP are the owner/employees of the business.

For S corporation ESOPs in existence on March 14, 2001, section 409(p) is effective for plan years beginning after Dec. 31, 2004. This delayed effective date has allowed existing S corporations that maintain ESOPs time to restructure the stock ownership in order to avoid the tax effects of section 409(p).

In addition, the IRS letters call attention to other abuses connected with S corporation ESOPs. "The IRS has determined that many existing arrangements designed to take advantage of the benefits of S corporation ESOP rules would not only involve taxation under section 409(p) but would also violate qualification requirements of the tax law, such as the coverage rules under Code section 410(b)," said Carol Gold, director of the IRS Employee Plans division. "When an ESOP is not qualified under such

circumstances, the subchapter S corporation may be taxable as a C corporation and any highly compensated ESOP participant may be taxable on the value of his or her account balance.”

The sponsor of an S corporation ESOP that may be involved in an arrangement described above should immediately consult a tax advisor. If the tax advisor determines that the arrangement is abusive, an amended return should immediately be filed for all open years affected by the arrangement. This issue may not be resolved under the Employee Plans Compliance Resolution System (EPCRS). Employee Plans anticipates initiating a compliance program to review a large number of S corporation ESOPs with small numbers of participants.

Additional information regarding section 409(p) and the temporary regulations, as well as other issues pertaining to ESOPs adopted by S corporations may be found on our Internet site. You can access the information at [www.irs.gov/ep](http://www.irs.gov/ep) by clicking on “S Corporation ESOP Guidance.”